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Technical Bulletin

Guidance on section 408 of the Companies Ordinance

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HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TECHNICAL BULLETIN

GUIDANCE ON SECTION 408 OF THE COMPANIES ORDINANCE

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INTRODUCTION

1. The Companies Ordinance (Cap. 622) (“CO”) was enacted on 12 July 2012. One of the measures introduced is a new offence imposed by section 408 in relation to certain omissions in auditor’s reports. The offence would be committed if an auditor in question knowingly or recklessly caused certain statements required by section 407(2)(b) and (3) to be omitted from the auditor’s report. The term “auditor” is used throughout this Technical Bulletin (“AATB”) to mean every person specified in section 408(2).
2. The requirements apply to an auditor’s report in respect of financial statements prepared pursuant to section 405 of the CO for financial periods that begin on or after the commencement date (3 March 2014) of the CO, i.e. typically the first set of financial statements covered would be for a financial period ending on or after 2 March 2015. Generally, for companies incorporated prior to 3 March 2014 with a calendar year end, the first applicable financial period is for the year ending 31 December 2015.
3. The objectives of this AATB are to:
 - set out the relevant sections in the CO to which the penalty sanctions apply;
 - consider the implications of those sections; and
 - provide guidance on the auditor’s reporting for statutory purposes.

This AATB focuses on penalty sanctions related to section 407(2)(b) and (3) and section 408. Therefore, this AATB does not cover the auditor’s reporting responsibility under section 407(2)(a) and (4). The auditor should, however, be familiar with section 407(2)(a) and (4) in forming their audit opinion for Hong Kong incorporated companies.

4. The Companies Registry has issued an [External Circular No. 10/2014 “Offence Relating to Contents of Auditor’s Report”](#) (“External Circular”) to set out the general principles that apply when making decisions on whether a case should be prosecuted under section 408 of the CO or section 16 of the Companies (Revision of Financial Statements and Reports) Regulation. The Companies Registry has also published related [Frequently Asked Questions](#) on its website. This AATB should be read in conjunction with the External Circular.

REQUIREMENTS OF SECTION 408

5. An extract of section 408 (and also section 407) is reproduced in Appendix 1.

Policy objective of section 408

6. As stated in publicly-available literature¹ the policy objective of section 408 is to enhance the reliability and integrity of financial statements and to further improve the regulatory regime for auditors. The two statements concerned under section 407(2)(b) and (3) – that the auditor cannot obtain adequate information or explanation and that the financial statements are not in agreement with the accounting records – were considered by the Government of the Hong Kong Special Administrative Region (“Government”) to be important pointers to assist the users of a company’s financial statements to take an informed view about the financial statements. The criminal sanction is considered by the Government to be necessary to enforce the duty to make those two important statements when they are required.

Implications of section 408

7. The implication from section 408 is that if the auditor omits to report a matter required under section 407(2)(b) or (3), then the auditor is liable to be prosecuted under section 408.

¹ LC Paper No. CB(1)2183/11-12(01), paragraph 4. The Administration’s papers presented to the Bills Committee on Companies Bill are available at http://www.legco.gov.hk/yr10-11/english/bc/bc03/papers/bc03_ppr.htm.

8. Section 408 penalises a person if such a person “knowingly or recklessly” causes a statement required by section 407 (2)(b) or (3) to be omitted from the auditor’s report². According to the Government, section 408 is not intended to criminalise negligence³.

Test for “knowingly”

9. Where “knowingly” is included in the definition of an offence, it is clear that the requisite mental state is required for the commission of the offence, and it is necessary for the prosecutor to prove knowledge on the part of the offender of all material circumstances of the offence.
10. In order to successfully prosecute under the “knowingly” threshold in section 408, it will be necessary to prove that the person knew and caused the statement required to be included in the auditor’s report to be omitted.
11. Paragraph 8 of the External Circular states that for the mental element of “knowingly”, the evidential threshold is quite high. A person would be culpable if, at the time of the commission of the offence, the auditor knew and caused the specified statements to be omitted. This knowledge will be inferred from the evidence, including the evidence given by the auditor as to what the auditor actually knew. Knowledge will not be imputed on the basis of the person’s professional qualification.

Test for “recklessly”

12. To prove that someone has acted recklessly, it is necessary to show that the auditor was aware that an action or failure to act carried risks, that the auditor personally knew that the risks were not reasonable ones to take, and that despite knowing that, the auditor went ahead.
13. There is established legal authority on this test. The test for “recklessness” according to the principle set out in the case of *Sin Kam Wah v HKSAR* [2005] 2 HKLRD 375 at 391 C-E, is as follows, “*it has to be shown that the defendant’s state of mind was culpable in that he acted recklessly in respect of the circumstances if he was aware of a risk which did or would exist, or in respect of a result if he was aware of a risk that it would occur, and it was, in circumstances known to him, unreasonable to take the risk. Conversely a defendant could not be regarded as culpable so as to be convicted of the offence if, due to his age or personal characteristics he genuinely did not appreciate or foresee the risks involved in his actions.*”
14. The provision would only cover cases where there is evidence of the requisite mental state of “knowingly” or “recklessly” at the time of commission of the offence.
15. The Government has explained that mere negligence would not constitute recklessness⁴. The evidence considered in a case will be that at the date of the offence, and that there could be a conviction with evidence based on professional judgment with the benefit of hindsight should not be a concern⁵.
16. As regards the mental element of “recklessly”, a person would be culpable if, at the time of commission of the offence, the auditor was aware that an action or failure to act carried risks that the auditor knew were not reasonable ones to take, and that the auditor went ahead despite knowing that. An inexperienced member of an audit team would not be regarded as culpable if, owing to the auditor’s inexperience, the auditor genuinely did not appreciate or foresee the risks involved in omitting the specified statements.

FACTORS TO CONSIDER FOR PROSECUTION

17. The Prosecution Code 2013 (the “Code”) published by the Department of Justice sets out the relevant guidelines for prosecution. Under the Code, the decision to prosecute includes two required components. The first is that the admissible evidence available is sufficient to justify instituting or continuing proceedings. The second is that the general public interest must require that the prosecution be conducted.

² LC Paper No. CB(1)339/11-12(01), page 38.

³ LC Paper No. CB(1)2183/11-12(01), paragraph 13 and Companies Registry External Circular No 10/2014, paragraph 8.

⁴ LC Paper No. CB(1)1979/11-12(02), paragraph 9.

⁵ LC Paper No. CB(1)2183/11-12(01), paragraph 17.

Evidential Criteria

18. There must be legally sufficient evidence to support a prosecution; that is, evidence that is admissible and reliable and, together with any reasonable inferences able to be drawn from it, likely to prove the offence. The test is whether the evidence demonstrates a reasonable prospect of conviction. In the context of section 408, to start a prosecution requires, among other things, admissible and reliable evidence on the state of mind of the person concerned. The requisite mental element for commission of an offence is “knowingly” or “recklessly” causing any of the specified statements to be omitted from an auditor’s report. The offence does not criminalise negligence⁴. In the context of section 408, this should be considered a high threshold for conviction.
19. Paragraph 11 of the External Circular states that in considering evidence to support a prosecution, prosecutors will take into account the statutory role of the auditor under the CO and the applicable procedures and standards. In relation to the audit in question, the following factors will be relevant:
- the way in which the audit was planned and conducted;
 - where more than one individual auditor was involved, the structure and management of the audit team; and
 - the nature of the company the financial statements of which were being audited, and the way in which the auditor worked with its management and staff.
20. Paragraph 12 of the External Circular further states that to secure a conviction of the offence all elements of the offence must be proved beyond reasonable doubt.

Public Interest Criteria

21. Even where the first component of the prosecution test is satisfied, a prosecutor must consider the second component, the requirement of a prosecution is in the public interest⁶.
22. There can be no exhaustive list of the considerations to be addressed when making this assessment, but they include⁷:
- the nature and circumstances of the offence, including any aggravating or extenuating circumstances;
 - the seriousness of the offence: more serious offences, including those where a victim has suffered significant harm or loss, or where there have been multiple victims, are more likely to be prosecuted in the public interest;
 - the effect of a prosecution on Hong Kong law enforcement priorities;
 - any delay in proceeding with a prosecution and its causes;
 - whether or not the offence is trivial, technical in nature, obsolete or obscure;
 - the level of the suspect’s culpability;
 - the involvement of other suspects in the commission of the offence;
 - any cooperation from the suspect with law enforcement or demonstrated remorse: the public interest may be served by not prosecuting a suspect who has made admissions, demonstrated remorse, compensated a victim and/or cooperated with authorities in the prosecution of others;
 - any criminal history of the suspect;

⁶ Prosecution Code 2013, paragraph 5.8.

⁷ Prosecution Code 2013, paragraph 5.9.

- the attitude, age, nature or physical or psychological condition of the suspect, a witness and/or a victim;
 - the likely final disposition of the case;
 - the prevalence of the offence and any deterrent effect of a prosecution;
 - special circumstances that would affect the fairness of any proceedings;
 - the availability and efficacy of alternatives to prosecution, such as a caution, warning or other acceptable form of diversion.
23. Paragraph 14 of the External Circular states that the prosecutor must consider the justice of the situation and examine all the factors. The factors will vary from case to case, but, in general, the more serious the offence, the more likely it is that the public interest will require a prosecution to proceed.

PERSONS LIABLE

24. Section 408 provides that any of the persons specified below commits an offence if the person knowingly or recklessly causes any of the specified statements to be omitted from an auditor's report:
- if the auditor is a natural person, the auditor and every employee and agent of the auditor who is eligible for appointment as auditor of the company;
 - if the auditor is a CPA firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company;
 - if the auditor is a body corporate, every officer, member employee and agent of the auditor who is eligible for appointment as auditor of the company.
25. Paragraph 3 of the External Circular explains that "employee" of the auditor refers to someone who is employed by the auditor who prepares the auditor's report whether the auditor is a natural person, a firm or a body corporate. An employee or agent of the auditor will be held liable only if he is eligible for appointment as auditor of the company and if he knowingly or recklessly causes any of the specified statements to be omitted.
26. Section 20AAZZR(1) of the Accounting and Financial Reporting Council Ordinance (Cap. 588) ("AFRCO") states that a person that is not a certified public accountant (practising), a CPA firm or a corporate practice must not hold any appointment or render any services, whether paid or unpaid, as — (a) an auditor of a company within the meaning of the CO; or (b) an auditor of accounts for the purposes of any other Ordinance.
27. Paragraph 4 of the External Circular further explains that the reference to a person eligible for appointment as auditor of the company in section 408 is not intended to cover any person who might have been eligible had he or she applied for the relevant professional qualifications or certificates (but did not do so).

PENALTY

28. The offence under section 408 is a summary offence for enforcement against non-compliance with the requirements in relation to the contents of the auditor's report. An auditor who commits an offence under section 408 is liable to a fine not exceeding \$150,000. It is a separate and distinct offence that would be enforced independently from misconduct proceedings pursued under the AFRCO.
29. In general terms, a "summary offence" describes a relatively less serious offence, whereas an "indictable offence" describes a more serious offence. A summary offence can only be tried in a Magistrates' Court without a jury. The only exception is that a summary offence can be tried in the District Court if the accused person is also charged with an indictable offence.

30. Regarding the timeframe for prosecution of a summary offence, section 900 of the CO provides that, despite section 26 of the Magistrates Ordinance, information or a complaint relating to an alleged offence under the CO may be tried if it is laid before or made to a magistrate (a) within three years after the commission of the offence and (b) within 12 months after the date on which the supporting evidence came to the Secretary for Justice's knowledge.

GUIDANCE ON THE AUDITOR'S REPORT FOR STATUTORY PURPOSES

31. As mentioned in paragraph 19 above, in considering evidence to support a prosecution, prosecutors will take into account the statutory role of the auditor under the CO and the applicable procedures and standards.
32. When an auditor has been engaged to perform an audit of a set of general purpose financial statements of a Hong Kong company under the requirements of the CO, the audit should conform to the Hong Kong Standards on Auditing ("HKSA").
33. Section 407 of the CO, in effect, continues the requirements in section 141 of the predecessor Ordinance, with the addition of a materiality component.
34. The principles and requirements in HKSA include performing procedures on accounting records and obtaining sufficient appropriate audit evidence for the audit of financial statements which also address the requirements of section 407(2)(b) and (3).
35. The following guidance is relevant for the auditor when considering section 407(2)(b) and (3). It is not intended to be exhaustive and members should read the HKSA for further guidance.
- paragraph 20 of HKSA 330, *The Auditor's Responses to Assessed Risks* requires the auditor's substantive procedures to include audit procedures related to the financial statement closing process such as agreeing or reconciling the financial statements with the underlying accounting records and examining material journal entries and other adjustments made during the course of preparing the financial statements.
 - paragraph 26 of HKSA 330 requires the auditor to conclude whether sufficient appropriate audit evidence has been obtained. Whether sufficient appropriate audit evidence has been obtained to reduce audit risk to an acceptably low level, and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion, is a matter of professional judgment. Some audit evidence is obtained by performing audit procedures to test the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements.
 - paragraph 8 of HKSA 230, *Audit Documentation* states that the auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:
 - (a) The nature, timing, and extent of the audit procedures performed to comply with the HKSA and applicable legal and regulatory requirements;
 - (b) The results of the audit procedures performed, and the audit evidence obtained; and
 - (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.
 - paragraph 11 of HKSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* requires the auditor to take into account the following:
 - the auditor's conclusion, in accordance with HKSA 330, whether sufficient appropriate audit evidence has been obtained;

- the auditor's conclusion, in accordance with HKSA 450, *Evaluation of Material Misstatements Identified during the Audit*, whether uncorrected misstatements are material, individually or in aggregate; and
- the evaluation requirements by paragraphs 12-15 of HKSA 700 (Revised).
- paragraph 17 of HKSA 700 (Revised) states that if the auditor:
 - concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
 - is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement,

the auditor shall modify the opinion in the auditor's report in accordance with HKSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

36. The requirements in section 407(2)(b) and (3) include the consideration of materiality. As there is no definition of materiality in the CO, members should apply the principles and requirements in HKSA 320, *Materiality in Planning and Performing an Audit*.

37. The following are some circumstances which members should be mindful of:

- Going concern

HKSA 570 (Revised), *Going Concern* requires the auditor to evaluate whether or not the going concern assumption is an appropriate basis of preparation of the financial statements. Depending on the facts and circumstances, this may result in one of the following outcomes:

 - (i) the auditor's report is unmodified – the auditor is satisfied that, based on evidence obtained, the going concern basis of preparation is appropriate and where necessary, that adequate disclosures are set out in the notes to the financial statements.
 - (ii) the auditor's report is modified in some way, such as the inclusion of an emphasis of matter paragraph under HKSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, a qualification or a disclaimer of opinion in respect of a limitation of scope under HKSA 705 (Revised) etc.

Where the auditor has issued an unmodified opinion or solely included an emphasis of matter paragraph in the report, ordinarily that would indicate the auditor has obtained sufficient appropriate audit evidence so as to satisfy section 407(3). Generally, where the auditor has issued a qualified opinion or disclaimer of opinion due to a limitation on the scope of the audit, it would result in a requirement to report under section 407(3).

- Outstanding matters

During an audit, the auditor will plan to perform various procedures including obtaining corroborative evidence. It can happen, for example, that the auditor may request certain information (e.g. debtor confirmations) which may not have been received at the time of the auditor's report. In such case, the auditor will need to evaluate if alternative procedures need to be performed. In these situations, when sufficient appropriate alternative procedures have been performed, the existence of outstanding matters does not of itself represent the auditor's failure to obtain all the information or explanations that are necessary and material for the purpose of the audit, and thus ordinarily the auditor would not need to make a statement as contemplated in section 407(3).
- Adjustments

Typically during the audit process there will be late adjustments to the financial statements or adjustments arising from the application of different financial reporting standards (commonly known as GAAP adjustments) between the GAAP used in maintaining books

and records as compared with the GAAP applied in preparing financial statements. At the time of completion of the auditor's report, those adjustments may not have been incorporated in the company's books and records. Nevertheless, if the auditor is satisfied that the company has maintained records of all adjustments such that the financial statements agree or reconcile to the trial balance and has sufficient records of the financial impact of such adjustments, then it is reasonable for the auditor to conclude that it is not necessary to state in his report, that the financial statements are not in agreement with the accounting records in any material respect as contemplated in section 407(2)(b).

- Significant prior year adjustments

Prior year adjustments relating to errors in past financial statements may be identified in the current year's audit. These may lead to prior year adjustments being disclosed in the current year financial statements in respect of financial statements of a previous year.

Adjustments in respect of prior year financial statements do not ordinarily mean that the auditor at the time when reporting on those financial statements, should have reported any matter under sections 407(2)(b) and 407(3). In respect of the current year auditor's report, if the auditor is satisfied that he or she has obtained all necessary evidence in respect of the comparative information included in the current year financial statements as required by HKSA 710, *Comparative Information – Corresponding Figures and Comparative Financial Statements*, this would not indicate the auditor needs to make a statement to comply with section 407(2)(b) or 407(3).

- Modified auditor's reports

Where an auditor has issued a modified auditor's report, the auditor should consider whether the issue(s) leading to the modified opinion should also be reported under section 407(2)(b) or 407(3).

Generally, where the auditor has issued a qualified opinion or disclaimer of opinion due to a limitation on the scope of the audit, it would result in a requirement to report under section 407(3).

- Modified auditor's reports – quantification of material misstatement in the financial statements

Paragraph 17 of HKSA 705 (Revised) requires that when the auditor issues a modified opinion due to a material misstatement in the financial statements that relates to specific amounts in the financial statements, the basis for modification paragraph should include a description and quantification of the financial effects of the misstatement. If it is not practicable to quantify the financial effects, the auditor shall so state in the basis for modification paragraph. However, for the avoidance of doubt, where the auditor includes a statement in the auditor's report that it is not practicable to quantify the effects of a material misstatement as required under paragraph 17 of HKSA 705 (Revised), this is not considered to be within the scope of section 407(3).

REPORTING OF MATTERS UNDER SECTION 407(2)(b) AND (3)

38. If the auditor is of the opinion that the financial statements of a company are not in agreement with its accounting records in any material respect or if the auditor has failed to obtain all the information or explanations that are necessary and material for the purpose of the auditor; the auditor must state that opinion or fact in the auditor's report. The absence of any statement or comment in the auditor's report in respect of these matters is equivalent to the fact that the auditor is satisfied with each of them based on the procedures he or she performed in accordance with HKSAs. Example auditor's reports are illustrated in HKSA 705 (Revised).

Appendix 1

Extract of sections 407 and 408 of the Companies Ordinance

407. Auditor's opinion on other matters

- (1) In preparing an auditor's report, the auditor must carry out an investigation that will enable the auditor to form an opinion as to—
 - (a) whether adequate accounting records have been kept by the company; and
 - (b) whether the financial statements are in agreement with the accounting records.
- (2) A company's auditor must state the auditor's opinion in the auditor's report if the auditor is of the opinion that—
 - (a) adequate accounting records have not been kept by the company; or
 - (b) the financial statements are not in agreement with the accounting records in any material respect.
- (3) If a company's auditor fails to obtain all the information or explanations that, to the best of the auditor's knowledge and belief, are necessary and material for the purpose of the audit, the auditor must state that fact in the auditor's report.
- (4) If the financial statements do not comply with section 383(1), the auditor must include in the auditor's report, so far as the auditor is reasonably able to do so, a statement giving the particulars that are required to be, but have not been, contained in the financial statements.

408. Offences relating to contents of auditor's report

- (1) Every person specified in subsection (2) commits an offence if the person knowingly or recklessly causes a statement required to be contained in an auditor's report under section 407(2)(b) or (3) to be omitted from the report.
- (2) The persons are—
 - (a) if the auditor who prepares the auditor's report is a natural person—
 - (i) the auditor; and
 - (ii) every employee and agent of the auditor who is eligible for appointment as auditor of the company;
 - (b) if the auditor who prepares the auditor's report is a firm, every partner, employee and agent of the auditor who is eligible for appointment as auditor of the company; or
 - (c) if the auditor who prepares the auditor's report is a body corporate, every officer, member, employee and agent of the auditor who is eligible for appointment as auditor of the company.
- (3) A person who commits an offence under subsection (1) is liable to a fine of \$150,000.